China: Shadow banking shrinking

China's loan data shows that shadow banking is shrinking, this could be the result of financial deleveraging reform. We expect the reform to continue for the rest of 2018

Source: Shutterstock

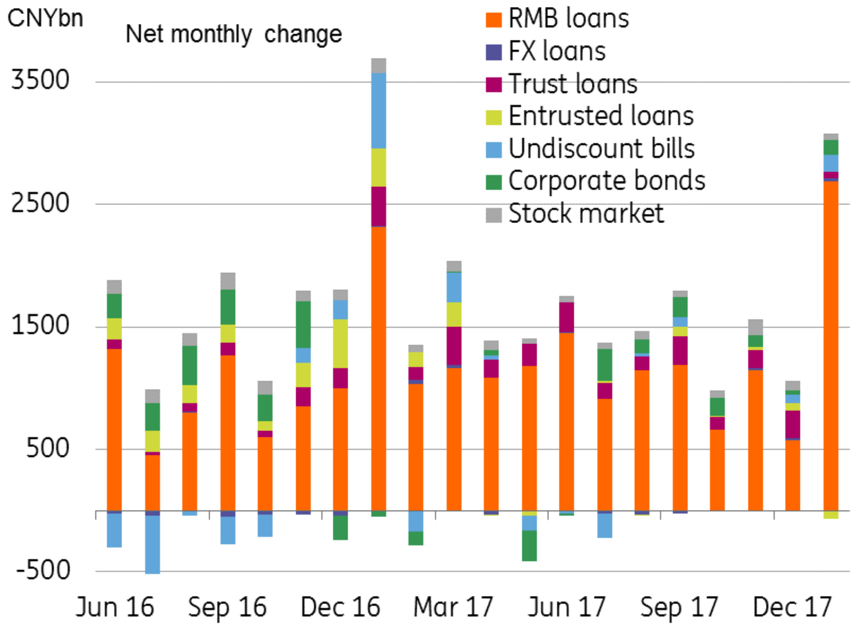
China may have succeded in reining in shadow banking

Data released by the Chinese central bank (PBoC) reflects that core shadow banking items shrank in total social financing, a measure of standard banking plus shadow banking activities. Meanwhile, loans going to standard channels, namely, new yuan loans grew 40% year-on-year to CNY2.69 trillion and contributed 87.9% of total social financing.

Even though banks are usually eager to book loans at the beginning of the year in order to enjoy a full year of interest income, it seems that financial regulators, including the central bank, the banking regulator, insurance regulator and the securities regulator, have gained some success in limiting shadow banking activities. New trust loans fell to CNY45.5 billion, and new entrusted loans contracted by CNY71.4 billion, which resulted in a 17%YoY reduction of total social financing.

Shadow banking items have moved to yuan loans

Core shadow banking items are trust loans, entrusted loans and undiscounted bankers acceptance



Source: ING, Bloomberg

Core shadow banking = trust loan + entrusted loan + undiscounted bankers acceptance

CNY2.7tr New yuan loans

Jan 2018

Implication for 2018 - tightness of liquidity to continue

The change in the structure of total social financial shows that the impact of financial deleveraging reform may have started to kick in. We expect yuan loans to continue to grow faster than shadow banking items in 2018. We believe that this is only the beginning of financial deleveraging in China. This success needs further policy consolidation.

It is therefore likely that the central bank will tighten liquidity for the rest of the year. The recent temporary liquidity injection was to avoid spikes in short-term interest rates around the Chinese New Year. After the Chinese New Year, we expect to see more regulations on financial deleveraging. And that could be the result of tighter liquidity through daily open market operations.

Aside from tightening through daily liquidity management, we expect the central bank to follow the Fed in raising interest rates (or the 7D reverse repo rate) three times in 2018. But as liquidity tightening could have already pushed up short-term rates by then, the magnitude of the PBoC's rate hike could be as mild as five basis points, the same as the December hike.

This is to make sure that the PBoC would not create an environment where interest rates in China are too high. It is true that financial deleveraging needs higher interest rates to drive out poor quality corporates and financial institutions, so the regulators would also be careful enough not to create a liquidity or credit crunch.

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